UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

IN RE ENRON CORPORATION SECURITIES LITIGATION	Consolidated Civil Action No. H-01-3624
This Document Relates To: MARK NEWBY, et al., individually and on behalf of all others similarly situated, Plaintiffs, v. ENRON CORPORATION, et al., Defendants.	
THE REGENTS OF THE UNIVERSITY OF CALIFORNIA, et al., individually and on behalf of all others similarly situated, Plaintiffs, v. KENNETH L. LAY, et al., Defendants.	

MEMORANDUM OF LAW OF MERRILL LYNCH & CO., INC.
IN SUPPORT OF ITS MOTION TO DISMISS

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Defendant Merrill Lynch & Co., Inc. ("Merrill Lynch") respectfully submits this memorandum of law in support of its motion, pursuant to Fed. R. Civ. P. 12(b)(6), to dismiss with prejudice plaintiffs' Consolidated Complaint (the "Complaint") as against Merrill Lynch for

failure to state a claim and failure to plead fraud with the particularity required by Rule 9(b) and the Private Securities Litigation Reform Act.

PRELIMINARY STATEMENT

Plaintiffs' Consolidated Complaint, filed nearly six months after the initial complaints in this matter, for the first time names Merrill Lynch and a host of other defendants. The obvious reason for this addition of new defendants is plaintiffs' fear that the original defendants – Enron Corporation ("Enron"), its officers and directors, and its auditor, Arthur Andersen – may be unable to satisfy whatever judgment plaintiffs may obtain against them herein. Plaintiffs thus seek to hold Merrill Lynch and others responsible for the alleged conduct of the original defendants.

As this Court is well aware, however, in recent years two developments have effected tectonic shifts in the law governing federal securities fraud actions, especially those pled not against the issuer of the securities in question but rather against the peripheral professional organizations who provided services to the issuer, including lawyers and underwriters. Those two developments were:

(a) the enactment of the Private Litigation Securities Reform Act, which heightened the pleading burden that had been in effect in this Circuit concerning allegations of scienter, and

(b) the Supreme Court's decision in *Central Bank of Denver N.A. v. First Interstate Bank of Denver*, which overruled a generation of established case law in this and every other Circuit under which lower courts had implied a private right of action for plaintiffs in securities fraud cases against defendants for "aiding and abetting" a fraud committed by others.

The net result of these two developments, which we discuss in detail below, was to eliminate in the vast majority of securities fraud cases any possibility of a private right of action against peripheral professionals like underwriters and analysts. The formerly tried and true

boilerplate "aiding and abetting" causes of action had to be deleted from plaintiffs' counsel's word processing systems, and any effort to recast old-fashioned secondary liability claims as "primary violations" (which are now the only recognized violations) of the 1934 Act was rendered substantially more difficult, if not outright impossible, by the enhanced pleading requirements imposed by the Reform Act.

These two developments have had an enormous practical impact because in many cases, and this is no exception, the issuer and its insiders may lack the financial wherewithal to answer to whatever judgment might be imposed upon them. Professional plaintiffs' securities law firms have therefore had substantial incentive to attack relentlessly the walls established by the Reform Act and *Central Bank.*

The claim in this case against Merrill Lynch must be read through this filter to be seen for what it is: a futile effort to resuscitate aiding and abetting, secondary liability in securities fraud cases. The allegations against Merrill Lynch are merely descriptions (albeit laden with pejorative and colorful adjectives) of its role as an underwriter, placement agent, lender, investor, and analyst. These descriptions (which could apply to any investment bank or broker-dealer in virtually every securities case) are then coupled with wholly conclusory allegations that Merrill Lynch knowingly made false statements. No effort is made to support that conclusion, and it is unsupportable. Nor should anyone be impressed by the sheer size of the pleading filed by plaintiffs; notwithstanding its bulk, it provides no specificity concerning any alleged wrongdoing by Merrill Lynch, but instead seeks to hold Merrill Lynch liable based solely on its association with Enron.

The Section 10(b) claim alleged against Merrill Lynch must be dismissed for the following reasons: First, Merrill Lynch did not underwrite any offerings of Enron securities

within the three years prior to the filing of the Complaint, and therefore any claims arising out of such offerings are barred by the three-year statute of repose. Second, plaintiffs fail to specify the statements made by Merrill Lynch alleged to be fraudulent or to explain why they are fraudulent, as required by the Reform Act and Rule 9(b) of the Federal Rules of Civil Procedure. Third, plaintiffs plead no specific facts whatsoever supporting any inference – much less the strong inference required by the Reform Act – that Merrill Lynch knew that any of its statements (or, for that matter, any of Enron's statements) were false or misleading. Finally, plaintiffs' principal theory of liability against Merrill Lynch – that it somehow, by performing duties as an investment bank, "participated" in the alleged fraud perpetrated by Enron – is precluded by the Supreme Court's holding in *Central Bank*.

The Reform Act and *Central Bank* thus bar the claim in this case against Merrill Lynch, and the Complaint must be dismissed with prejudice as against it.

STATEMENT OF FACTS

A. Procedural Posture

The first lawsuits in this matter were filed on October 22, 2001. The suits initially named Enron, certain of its current and former officers and directors, and its auditor Arthur Andersen. On December 12, 2001, this Court issued an order consolidating all federal securities actions concerning Enron pending in the Southern District of Texas, and on February 15, 2002, the Court appointed the Regents of the University of California lead plaintiff. On April 8, 2002, plaintiffs filed their Consolidated Complaint. The Consolidated Complaint names Merrill Lynch as a defendant for the first time. Plaintiffs bring just one claim against Merrill Lynch, alleging a violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and SEC Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5. Compl. ¶¶ 992-97.

B. Enron Corporation

Enron was formed in 1985 with a primary focus on the operation of natural gas pipelines. Compl. ¶ 5. Between 1985 and 2001, Enron expanded its business to include trading of wholesale energy resources and services, operating power plants, providing retail energy services, and building a large broadband network. Compl. ¶ 6. By mid-2001, Enron was one of the world's leading energy, commodities, and service companies with operations around the world. For 2000, Enron reported annual revenues of $100 billion and net income of $1.2 billion. Compl. ¶ 12. Arthur Andersen issued unqualified opinions on Enron's annual financial statements for each of 1997, 1998, 1999, and 2000. Compl. ¶ 899.

On October 16, 2001, Enron announced charges to earnings of $1.01 billion associated with certain of its investments. Compl. ¶¶ 61, 364. Shortly thereafter, Enron announced a reduction of shareholder equity of $1.2 billion. Compl. ¶ 61. The capital markets responded quickly to the news, driving down the price of Enron securities, and the first lawsuits alleging securities fraud were filed against Enron and its officers and directors within a week. Merrill Lynch was not named as a defendant in any of these lawsuits. Within two weeks, the SEC launched a formal investigation of Enron, and Enron's board appointed an independent committee to examine related party transactions (which had been blamed in part for the October 16 charge), and to take any other necessary actions.

On November 8, 2001, in a filing with the SEC, Enron announced the restatement of its financial statements for 1997 through the first two quarters of 2001. Compl. ¶¶ 61, 384. Enron's restatements reflected the consolidation onto its balance sheet of the assets and liabilities of certain previously unconsolidated entities. Compl. ¶ 61. As a result of this restatement, Enron reported significantly reduced net income for 1997 through the first two quarters of 2001.

Compl. ¶¶ 61, 384. The capital markets again responded to the news, driving down even further the price of Enron securities.

On November 9, 2001, Enron announced that it had signed a merger agreement with Dynegy Inc. By November 30, however, Enron's financial condition had failed to stabilize, its credit rating was downgraded below investment grade, and its proposed merger with Dynegy was terminated. Compl. ¶¶ 64-66. On December 2, 2002, Enron filed a voluntary petition for bankruptcy in the United States Bankruptcy Court for the Southern District of New York. Compl. ¶ 66.

C. Merrill Lynch & Co., Inc.

Merrill Lynch is a financial services company based in New York. Compl. ¶ 105.[1] On certain occasions, prior to Enron's bankruptcy, Merrill Lynch provided investment banking services to Enron and its affiliates or other related parties. Compl. ¶ 735. In addition, Merrill Lynch's financial analysts published reports for Merrill Lynch clients describing the financial performance of Enron and expressing opinions regarding its future prospects. Compl. ¶ 746.

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[1] Plaintiffs acknowledge that Merrill Lynch & Co., Inc., the only "Merrill Lynch" entity named as a defendant, does not itself directly engage in many of the activities attributed to "Merrill Lynch" in the Complaint, but rather that such activities, insofar as undertaken by any "Merrill Lynch" entity, would have been performed by subsidiaries or affiliates. Compl. ¶ 105. For purposes of this motion to dismiss, we adopt plaintiffs' use of the all-encompassing term "Merrill Lynch," without conceding that the Complaint describes conduct attributable to the defendant herein, Merrill Lynch & Co., Inc. (or, for that matter, to its subsidiaries or affiliates).

1. Merrill Lynch As Underwriter

From 1996 through 1999, Merrill Lynch participated in a relatively small number of securities underwritings for Enron.[2] Each of the Enron offerings for which Merrill Lynch served as an underwriter occurred more than three years before plaintiffs filed their Consolidated Complaint.[3] Plaintiffs have not asserted claims against Merrill Lynch under the Securities Act of 1933 in connection with any of the offerings.

Plaintiffs contend that Merrill Lynch is liable under Section 10(b) of the Securities Exchange Act of 1934 for allegedly false and misleading statements contained in the Registration Statement and Prospectus filed in connection with Enron's February 1999 offering of 27.6 million shares of common stock. Compl. ¶ 745. Plaintiffs' Section 10(b) claim relating to the February 1999 offering (as well as the other five offerings of Enron securities that plaintiffs allege in their Complaint involved Merrill Lynch) is barred, however, by the three-year statute of repose for Section 10(b) claims. Even if plaintiffs' Section 10(b) claim was not barred, plaintiffs have alleged no facts to support their contention that Merrill Lynch knew about the

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[2] Of the sixteen Enron securities offerings alleged in the Complaint, Merrill Lynch is alleged to have participated in six. Compl. ¶ 48.

[3] Plaintiffs' allegations regarding Merrill Lynch's participation in offerings are inconsistent. In Paragraph 48 of the Complaint, plaintiffs allege six offerings in which Merrill Lynch was involved, the most recent of which was a common stock offering that occurred in February 1999. In Paragraph 738, however, plaintiffs allege six offerings, the last of which – described as an offering of Enron "weather" bonds – allegedly occurred in October 1999. Merrill Lynch is unfamiliar with any offering of "weather" bonds (in October 1999 or at any other time), and because that offering is never mentioned again in the Complaint – and, in particular, because no misrepresentation is alleged with respect to such an offering – Merrill Lynch assumes that the allegation in Paragraph 738 is a mistake by plaintiffs' counsel. Even if not an error, plaintiffs do not purport to assert any claim arising out of that offering, and thus that offering is irrelevant on this motion to dismiss.

errors and omissions allegedly contained in the Enron financial statements incorporated into the Registration Statement and Prospectus for the February 1999 common stock issuance.

In addition to the Enron securities offerings, Merrill Lynch served as a co-underwriter in June 1999 for an issuance of common stock, and in February 2000 for notes, of Azurix Corp., a water company spun off from Enron. Compl. ¶¶ 49, 739. Investors in Azurix securities are not parties to this action and have not asserted claims against Merrill Lynch. Indeed, plaintiffs have failed to identify any statements attributable to Merrill Lynch from its underwriting of Azurix securities, and have not even attempted to articulate how Merrill Lynch's provision of investment banking services to Azurix could possibly defraud purchasers and sellers of Enron's securities.

2. Merrill Lynch As Research Analyst

Before Enron's bankruptcy, Merrill Lynch issued periodic research reports regarding Enron. Copies of the Merrill Lynch reports referred to in the Complaint are submitted as Exhibits B-P to the accompanying Declaration of Taylor M. Hicks, executed May 7, 2002.[4]

Plaintiffs contend that Merrill Lynch is liable to the purported class for "false and misleading statements in analysts' reports written and issued by Merrill Lynch, which helped to artificially inflate the trading price of Enron's publicly traded securities." Compl. ¶ 749. It is difficult to tell precisely what plaintiffs allege was false or misleading about Merrill Lynch's analyst reports, which consisted principally of summaries of Enron's reported financial results

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[4] On this motion to dismiss, this Court may properly consider "documents integral to and explicitly relied on in the complaint, that the defendant appends to his motion to dismiss, as well as the full text of documents that are partially quoted or referred to in the complaint." *In re Sec. Litig. BMC Software, Inc.*, 183 F. Supp. 2d 860, 882 (S.D. Tex. 2001) (Harmon, J.) (denying plaintiffs' motion to strike). In addition, "courts may routinely consider not just documents named in plaintiffs' complaint, but even documents that, if not named, are pertinent, central or integral to plaintiffs' claim." *Id.* at 883.

and opinions and projections regarding Enron's future prospects. The Complaint simply excerpts portions of those (and other banks') reports over many months, and then broadly and generally proclaims them "false or misleading" for failing to include certain other information. *See* Compl. ¶¶ 155, 214, 300, 339, 390. More importantly, plaintiffs' Complaint fails to demonstrate any basis for its naked assertion that Merrill Lynch or its financial analysts "knew that Enron was falsifying its publicly reported financial results and that its true financial condition was much more precarious than was publicly known." Compl. ¶ 748.

3. Merrill Lynch As Placement Agent For And Limited Partner In LJM2

As the apparent centerpiece of their claims against Merrill Lynch, plaintiffs contend that Merrill Lynch "was intimately involved in creating, structuring and helping to finance one of the primary vehicles of the Enron fraud – the LJM2 partnership." Compl. ¶ 740. Other than the fact that Merrill Lynch served as the "placement agent" for LJM2 (and itself invested in a limited partnership interest), plaintiffs provide no details regarding how Merrill Lynch supposedly "created and structured the LJM2 partnership." *Id.* Merrill Lynch is not alleged to have controlled, managed, operated, or selected investments for the limited partnership; as placement agent, Merrill Lynch simply sold interests in the partnership.

Plaintiffs contend that the private placement memorandum for LJM2 constituted a "blatant offer" to certain selected investors "to profit from self-dealing transactions with Enron whereby the investors in LJM2 were virtually guaranteed to reap huge returns." Compl. ¶ 740. Plaintiffs fail to mention that the private placement memorandum also contained extensive discussion of the significant steps that Enron represented that it would take to avoid a conflict of interest resulting from Mr. Fastow's role in LJM2, including that: "Richard Causey, Executive Vice President and Chief Accounting Officer of Enron, will, in behalf of Enron, monitor and

mediate conflict-of-interest issues between Enron and the Partnership." Private Placement Memorandum, at 12 (attached as Exhibit A to the Hicks Declaration).

Merrill Lynch also invested as a limited partner in LJM2, and, along with other banks, lent money to LJM2. Compl. ¶ 741-42.[5] Although plaintiffs have characterized Merrill Lynch's investment in LJM2 as a "reward" for its participation in an alleged fraudulent scheme, they have pointed to nothing suggesting that Merrill Lynch's investment in LJM2, and the investments of its clients and employees, were not fully at risk throughout the putative class period. Indeed, the investments of Merrill Lynch, its employees and clients in LJM2 remain at risk today.[6]

Plaintiffs contend that Merrill Lynch participated in a fraud by virtue of its knowledge of certain transactions entered into by LJM2 with Enron, including the so-called Raptor transactions (Compl. ¶¶ 31-35, 462-65, 477-95, 649) and certain asset purchases made by LJM2 from Enron at year-end 1999. Compl. ¶¶ 26-29, 469-74, 647. However, plaintiffs make no allegation concerning how Merrill Lynch supposedly learned that these transactions were inappropriate (if indeed they were), or that Enron was engaging in these transactions for the purpose of manipulating its financial statements (if indeed it was).

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[5] In a deliberately vague allegation apparently designed to suggest a much larger role for Merrill Lynch than it had, plaintiffs claim that "Merrill Lynch also provided financing to the LJM2 partnership via a $120 million line of credit." Compl. ¶ 742. In fact, Merrill Lynch was merely one of a number of banks, each with only a fraction of the line of credit, as plaintiffs acknowledge by making a similar allegation regarding Credit Suisse First Boston. *See* Compl. ¶ 712.

[6] Plaintiffs contend that investors were "assured" that LJM2 "would generate returns of at least 30% per year," and that they "were virtually guaranteed to reap huge returns." Compl. ¶ 740. The Private Placement Memorandum, however, merely stated that the partnership's "objective" was to generate an annualized rate of return in excess of 30%. Private Placement Memorandum, at 1 (Hicks Decl., Ex. A).

4. Boilerplate Allegations Against Merrill Lynch And Every Other Bank Defendant

The Complaint makes very few additional allegations that specifically involve Merrill Lynch. Plaintiffs allege that Merrill Lynch had "an extensive and extremely close relationship with Enron" (Compl. ¶ 735) and that "top executives of the firm constantly interacted with top executives of Enron." Compl. ¶ 736. Plaintiffs have made the exact same allegations against every other bank named in the Amended Complaint.[7] Plaintiffs also contend that Merrill Lynch obtained knowledge of Enron's alleged misdeeds "due to its access to Enron's internal business and financial information as one of Enron's main underwriters and financial advisors, as well as its intimate interaction with Enron's top officials which occurred virtually on a daily basis." Compl. ¶ 748. This boilerplate claim is also made, in substantially identical language, against all of the other banks named as defendants.[8]

Throughout the litany of Enron's allegedly improper transactions and accounting misdeeds set forth in plaintiffs' Consolidated Complaint, Merrill Lynch's name is conspicuously absent. Other than its participation as a passive investor in LJM2, which, for the reasons discussed below, is insufficient to support a claim of fraud, Merrill Lynch is not alleged to have any connection to this activity. Thus, there is no mention of Merrill Lynch in plaintiffs' discussions of "Special Purpose Entities" such as Chewco and JEDI (Compl. ¶¶ 435-47), LJM1 (Compl. ¶¶ 448-59, 466-75), Firefly (Compl. ¶ 496), JV-Company (Compl. ¶ 496), or Osprey Trust and Marlin Trust (Compl. ¶¶ 497-505). Similarly, Merrill Lynch is mentioned nowhere in

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[7] *See* Compl. ¶¶ 652-53, 674-75, 693-94, 715-16, 750-51, 762-63, 773-74, 787-88 (identical allegations against JP Morgan Chase, CitiGroup, Credit Suisse First Boston, CIBC, Barclays, Lehman Brothers, Bank of America and Deutsche Bank).

[8] *See* Compl. ¶¶ 670, 689, 713, 733, 760, 771, 784, 798.

plaintiffs' discussion of Enron's broadband transactions (Compl. ¶¶ 520-32), its use of mark-to-market accounting (Compl. ¶¶ 533-57), or its forward sales contracts with certain commercial banks and the State of Connecticut (Compl. ¶¶ 558-74). Finally, there is no mention of Merrill Lynch in plaintiffs' discussion of Enron's accounting for certain long term contracts, unsuccessful bids, and investment assets. Compl. ¶¶ 575-609.

ARGUMENT

PLAINTIFFS' SECTION 10(b) CLAIM AGAINST MERRILL LYNCH SHOULD BE DISMISSED FOR FAILURE TO STATE A CLAIM

Where, as here, plaintiffs have failed to plead adequately each required element of a purported claim, dismissal under Rule 12(b)(6) is warranted. *See Campbell v. City of San Antonio,* 43 F.3d 973, 975 (5th Cir. 1995). Only plaintiffs' well-pled allegations need be accepted and "the court is not required to conjure up unpled allegations or construe elaborately arcane scripts to save a complaint." *Id.* Moreover, "conclusory allegations or legal conclusions masquerading as factual conclusions will not suffice to prevent a motion to dismiss." *Id.*

In late 1995, Congress enacted the Private Securities Litigation Reform Act ("PSLRA") to combat abuses in securities fraud actions. H.R. Conf. Rep. No. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 730 ("The private securities litigation system is too important to the integrity of American capital markets to allow this system to be undermined by those who seek to line their own pockets by bringing abusive and meritless suits."). Together, Rule 9(b) of the Federal Rules of Civil Procedure and Section 21D of the PSLRA serve the express purpose of protecting the reputation of professionals from the kind of unsubstantiated fraud charges exemplified by this case. *See Melder v. Morris*, 27 F.3d 1097, 1100 (5th Cir. 1994) (affirming dismissal of securities fraud complaint against underwriter; "The heightened pleading standard of Rule 9(b) serves an important screening function in securities fraud

suits. . . . [It] provides defendants with fair notice of the plaintiffs' claims, protects defendants from harm to their reputation and goodwill, reduces the number of strike suits, and prevents plaintiffs from filing baseless claims then attempting to discover unknown wrongs."); H.R. Conf. Rep. No. 104-369, at 31 (in adopting PSLRA, Congress specifically sought to eliminate the "targeting of deep pocket defendants, including accountants, underwriters, and individuals . . . without regard to their actual culpability").

To state a claim under Section 10(b), plaintiffs must allege specific facts demonstrating (1) a misstatement or omission; (2) of a material fact; (3) made with scienter; (4) on which plaintiffs relied; (5) that proximately caused plaintiffs' injury. *BMC Software*, 183 F. Supp. 2d at 867 n.18 (Harmon, J.) (dismissing securities fraud complaint with prejudice).

For the reasons stated below, plaintiffs have failed to plead facts sufficient to state a claim against Merrill Lynch under Section 10(b), and the Complaint against Merrill Lynch should be dismissed.

A. Plaintiffs' Claim Against Merrill Lynch Based On Enron Offering Documents Is Barred By The Statute Of Repose

Plaintiffs purport to bring a claim against Merrill Lynch based on alleged false and misleading statements in Enron's Registration Statement and Prospectus for its common stock offering in February 1999, in which Merrill Lynch served as one of the lead underwriters. Compl. ¶¶ 745, 749. Plaintiffs' claim based on this offering, as well as any other Enron offering in which Merrill Lynch participated, is time-barred under the three-year statute of repose for Section 10(b) claims.[9]

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[9] The Complaint alleges Merrill Lynch's participation in several offerings prior to February 1999, although plaintiffs do not explicitly purport to base a claim on those offerings. Any

[Footnote continued on next page]

Under *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 364 (1991), claims under Section 10(b) "must be commenced within one year after the discovery of the facts constituting the violation and within three years after such violation." To the extent any of the offering documents contained misstatements allegedly attributable to Merrill Lynch, each of those statements was made more than three years before plaintiffs first named Merrill Lynch as a defendant in this action on April 8, 2002. *See Lampf*, 501 U.S. at 364 (dismissing Section 10(b) claim as time-barred because "plaintiffs-respondents' complaints were filed more than three years after petitioner's alleged misrepresentations"); *Wafra Leasing Corp. v. Prime Capital Corp.*, __ F. Supp. 2d __, 2002 WL 460826, at *7-8 (N.D. Ill. March 26, 2002) (three-year statute of repose runs from date of alleged misrepresentation); *In re Prudential Ins. Co. of Am. Sales Practices Litig.*, 975 F. Supp. 584, 603-04 (D.N.J. 1997) (same).

Plaintiffs' claim against Merrill Lynch, moreover, does *not* relate back to the filing of the original complaints in these cases. Those complaints named Enron, its officers and directors, Arthur Andersen, and others, but *not* Merrill Lynch. When a party is added by amendment, the claims against it do not relate back to the original filing unless, in addition to the claims meeting other requirements, the party to be brought in by amendment "knew or should have known that, but for a mistake concerning the identity of the proper party, the action would have been brought against the party." Fed. R. Civ. P. 15(c)(3); *Nelson v. Adams USA, Inc.*, 529 U.S. 460, 467 n.1 (2000); *Jacobsen v. Osborne*, 133 F.3d 315, 321 (5th Cir. 1998); *Duckworth v. Brunswick Corp.*, No. Civ. A. 700-CV-120-R, 2001 WL 406234, at *1-2 (N.D. Tex. Apr. 17, 2001). Plaintiffs

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[Footnote continued from previous page]
attempt by plaintiffs to bring a claim based on those offerings also would be barred for the reasons set forth in this section.

cannot credibly maintain that Merrill Lynch knew or should have known that it was left out of earlier actions "but for a mistake concerning [its] identity."

Accordingly, plaintiffs' Section 10(b) claim against Merrill Lynch arising out of any alleged misrepresentations in Enron offering documents is time-barred.[10]

B. Plaintiffs Fail To Specify The Statements In Merrill Lynch Analyst Reports Alleged To Be Fraudulent Or To Explain Why They Are Fraudulent

Plaintiffs' second theory of primary liability is equally spurious. According to plaintiffs, "Merrill Lynch issued securities analysts' reports on Enron or its analysts made statements to the media which contained false or misleading statements concerning Enron's business, finances and financial condition and its future prospects . . . which helped artificially inflate the trading prices of Enron's publicly traded securities." Compl. ¶ 746. Plaintiffs purport to identify roughly a dozen analyst reports and two "statements to the media," dating from January 1999 to October 2001, which were allegedly devised by Merrill Lynch to inflate Enron's stock. *Id.*[11] These allegations, however, fail to state a claim under Section 10(b).

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[10] By the same reasoning, plaintiffs' Section 10(b) claim relating to the two analyst reports issued by Merrill Lynch prior to April 8, 1999 (dated January 20, 1999 and March 31, 1999, *see* Compl. ¶¶ 130, 142) is also time-barred under the three-year statute of repose.

[11] Plaintiffs do not and cannot purport to state a fraud claim against Merrill Lynch for any alleged *omissions* in its analyst reports. *See In re Oak Tech. Sec. Litig.*, No. 96-20552, 1997 WL 448168, at *13 (N.D. Cal. Aug. 1, 1997) ("H&Q cannot be liable to plaintiffs under Section 10(b) for any omissions in its analyst reports . . . [because] no named plaintiff was a client of H&Q."); *In re Valence Tech. Sec. Litig.*, No. C 95-20459, 1996 WL 37788, at *9 (N.D. Cal. Jan 23, 1996) ("Plaintiffs contend that because Montgomery and Alex Brown chose to speak to the investment community through their analysts' reports, that they accepted a duty to disclose materially adverse facts. Plaintiffs do not cite any competent authority to support this contention. Accordingly, the Court hereby dismisses these allegations with prejudice.").

Under Rule 9(b) and the PSLRA, plaintiffs in securities fraud actions must "specify the statements contended to be fraudulent, identify the speaker, state when and where the statements were made, and explain why the statements were fraudulent." *BMC Software*, 183 F. Supp. 2d at 865 n.14 (quoting *Williams v. WMX Techs., Inc.*, 112 F.3d 175, 177 (5th Cir. 1997)); *see also* 15 U.S.C. § 78u-4(b)(1) ("the complaint shall specify each statement alleged to have been misleading [and] the reason or reasons why the statement is misleading").

Plaintiffs' Complaint fails to satisfy this threshold pleading requirement given the "puzzle-style" pleading it employs. *See, e.g., In re Splash Tech. Holdings Inc. Sec. Litig.*, 160 F. Supp. 2d 1059, 1073-75 (N.D. Cal. 2001). With respect to the allegedly fraudulent statements issued by Merrill Lynch analysts, "plaintiffs have left it up to defendants and the court to try to figure out exactly what the misleading statements are, and to match the statements up with the reasons they are false and misleading." *Id.* at 1074 (quoting *In re Autodesk, Inc. Sec. Litig.*, 132 F. Supp. 2d 833, 841 (N.D. Cal. 2000)). It is not the responsibility of this Court, nor should defendants be forced, to solve the puzzle of interpreting plaintiffs' claims. *See id.* at 1075.

Plaintiffs' Complaint, under the heading "Class Period Events and False Statements," recites a litany of statements allegedly attributable to Merrill Lynch analysts that were in some manner allegedly false or misleading. *See* Compl. ¶¶ 130, 142, 147, 149, 162, 181, 201, 208, 209, 226, 228, 250, 266, 321, 362.[12] Although plaintiffs at times quote from Merrill Lynch's reports, plaintiffs never state whether the quoted portion, some portion of the quote, or the

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[12] Although Paragraph 746 references an October 12, 1999 statement allegedly made by Merrill Lynch analyst Donato Eassey and published in Bloomberg, the Complaint nowhere details Mr. Eassey's statement.

bolded portion of the quote, is allegedly false. *See id.*[13] Compounding the problem, Merrill Lynch's allegedly false or misleading statements are listed together with statements attributable to all of the other defendants over periods of up to 12 months. Just as in *Splash Tech.*, plaintiffs then plead the false or misleading nature of all the defendants' statements in overarching paragraphs in which the reader is challenged to match the false statement previously alleged with the defendant and the precise "reason" that makes the statement false. *See Splash Tech.*, 160 F. Supp. 2d at 1074; Compl. ¶¶ 155, 214, 300, 339, 390. Plaintiffs' Complaint thus fails to "identify[] which alleged false statement(s) are belied by the facts stated in each 'reason.'" *Splash Tech.*, 160 F. Supp. 2d at 1073; *see also Chan v. Orthologic Corp.*, No. Civ. 96-1514,

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[13] Not surprisingly, plaintiffs' quotes from Merrill Lynch's analyst reports are highly selective sound bites, which omit the greater context of those reports. And although it is impossible to tell which portions of the reports are alleged to be false, the bulk of the quoted excerpts are vague, general statements of optimism that are nonactionable because reasonable investors would not consider such statements to be material. *See Krim v. BancTexas Group, Inc.*, 989 F.2d 1435, 1446 (5th Cir. 1993) ("projections of future performance not worded as guarantees are generally not actionable under the federal securities laws"); *Kurtzman v. Compaq Computer Corp.*, Civ. A. No. H-99-779, slip op. at 52 (S.D. Tex. Mar. 30, 2002) (Harmon, J.) ("Vague optimistic statements are not actionable because reasonable investors do not rely on them in making investment decisions.") (citation omitted); *In re MCI WorldCom, Inc. Sec. Litig.*, 191 F. Supp. 2d 778, 785-86 (S.D. Miss. 2002) (listing examples of nonactionable statements); *Strassman v. Fresh Choice, Inc.*, No. C-95-20017, 1995 WL 743728, at *16 (N.D. Cal. Dec. 7, 1995) (dismissing securities fraud complaint against underwriter based on analyst reports which contained statements "too vague to be materially misleading as a matter of law"). Statements of this type allegedly made by Merrill Lynch include the following: "the sky seems to be the limit for this group" (Compl. ¶ 130); "Phase I of the Dabhol project . . . should be a strong contributor to earnings" (Compl. ¶ 142); "we do not see ENE's growth rate slowing any time soon" (Compl. ¶ 147); "ENE is very well managed" (Compl. ¶ 162); "ENE continues to demonstrate its dexterity in delivering solid earnings growth even in challenging energy markets" (Compl. ¶ 181); "ENE posted another solid quarter and year" (Compl. ¶ 201); "they are the real deal" (Compl. ¶ 209); "Enron is positioned to be the GE of the new economy" (Compl. ¶ 228); "ENE will continue to experience strong growth" (Compl. ¶ 250); "retail is also kicking into high gear" (Compl. ¶ 266); "operating growth continues to soar" (Compl. ¶ 321); "ENE is well on its way to re-sharpening its focus" (Compl. ¶ 362).

1998 WL 1018624, at *14 n.11 (D. Ariz. Feb. 5, 1998) ("Such repeated lists of 'specific' reasons make a mockery of Rule 9(b) and the Reform Act. . . . The requirement that Plaintiff show why *each* statement is false or misleading when made [can]not be met by listing all statements and then ending with this laundry list to show why the statements are troublesome.") (emphasis in original).

This manner of pleading fails to give even the most basic notice to defendants of the claims against them and, accordingly, falls well short of compliance with the requirements of the PSLRA and Rule 9(b). *See Splash Tech.*, 160 F. Supp. 2d at 1074-75.

C. Plaintiffs Fail To Plead Facts Giving Rise To A Strong Inference Of Scienter

1. The PSLRA Imposes Heightened Pleading Requirements for Scienter

The PSLRA imposes strict pleading requirements regarding the element of scienter. In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976), the Supreme Court stated that plaintiffs alleging securities fraud must adduce proof of "intent to deceive, manipulate or defraud."

Historically, the Fifth Circuit "only mandated that the specific facts alleged 'support an inference of fraud.'" *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 407 (5th Cir. 2001) (quoting *Tuchman v. DSC Communications Corp.*, 14 F.3d 1061, 1068 (5th Cir. 1994)). There were two ways to establish an "inference of fraud." The first was "by alleging facts that show a defendant's motive to commit securities fraud." *Id.* at 409. The second was to plead facts constituting circumstantial evidence of conscious misbehavior or "severe recklessness." *Id.* at 407-09.

Section 21D of the PSLRA, however, provides that "the complaint shall, with respect to each act or omission alleged to violate this chapter, *state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.*" 15 U.S.C. § 78u-

4(b)(2) (emphasis added). The Fifth Circuit interprets this provision of the PSLRA as "mak[ing] clear that our previous rule, which required that a plaintiff plead facts that merely 'support an inference of fraud,' has been supplanted by the PLSRA's 'strong inference' requirement." *Nathenson*, 267 F.3d at 407; *see also Schiller v. Physicians Resource Group, Inc.*, No. Civ. A. 3:97-CV-3158-L, 2002 WL 318441, at *6 (N.D. Tex. Feb. 26, 2002) (dismissing securities fraud complaint with prejudice because "a mere reasonable inference is [now] insufficient to survive a motion to dismiss"). The Fifth Circuit thus requires that securities fraud plaintiffs plead "particularized facts giving rise to a *strong* inference of scienter." *Nathenson*, 267 F.3d at 412 (emphasis added).

As a result, "evidence of a defendant's motive and opportunity to commit securities fraud does not constitute 'scienter' for the purposes of Section 10(b) or Rule 10b-5 liability . . . [and] what must be alleged is not motive and opportunity as such but particularized facts giving rise to a *strong* inference of scienter." *Nathenson*, 267 F.3d at 410-12 (emphasis added). *See also Zishka v. American Pad and Paper Co.*, No. Civ. A. 3:98-CV-0660-M, 2001 WL 1645500, at *2 (N.D. Tex. Dec. 20, 2001) ("The *Nathenson* court found . . . that the passage of the PSLRA rendered motive and opportunity pleading alone insufficient for purposes of alleging scienter.").

To satisfy this heightened standard, securities fraud plaintiffs "must allege what actions each defendant took . . . and specifically plead what he learned, when he learned it, and how plaintiffs know what he learned." *BMC Software*, 183 F. Supp. 2d at 886. Moreover, the alleged facts must constitute "persuasive, effective, and cogent evidence from which it can logically be deduced that defendants acted with intent to deceive, manipulate, or defraud." *Physicians Resource Group*, 2002 WL 318441, at *6.

The Complaint here is utterly devoid of such specifics with regard to the claim against Merrill Lynch. Plaintiffs do not, and cannot, identify any facts that would support an inference, much less a *strong* inference, of fraudulent intent on the part of Merrill Lynch.

2. Plaintiffs Do Not And Cannot Demonstrate That Merrill Lynch Had Any Motive To Defraud

As the Fifth Circuit held in *Nathenson*, "[a]llegations of motive and opportunity held previously to the PSLRA to be insufficient to allow a proper inference of scienter . . . would presumably continue to be insufficient." 267 F.3d at 412. Here, the Complaint fails even to satisfy the lesser, and now rejected, pleading standard of "motive and opportunity," and for that reason necessarily fails to meet the more rigorous standard imposed by the PSLRA.

Under the pre-PSLRA standard, allegations of motive had to "entail concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged." *BMC Software*, 183 F. Supp. 2d at 897. Plaintiffs do not identify any "concrete" benefits that Merrill Lynch allegedly received in connection with its underwriting activity or analyst reports.

As the Fifth Circuit has made clear, allegations that an underwriter was motivated by fees to perpetrate fraud in a client's offering are irrational, and are therefore inadequate to establish the underwriter's scienter. *See Melder*, 27 F.3d at 1104 ("The plaintiffs merely allege that the underwriters 'agreed to participate in the wrongdoing alleged herein in order to obtain substantial fees, expenses and discounts in connection with the Offerings.' . . . Simply put, accepting the plaintiffs' allegation of motive as sufficient would make a mockery of Rule 9(b) by effectively eliminating the scienter requirement as to securities underwriters since all underwriters are, of course, fee seekers."); *see also Chan*, 1998 WL 1018624, at *23 ("it is clear that under *any* test underwriting commissions do not establish scienter") (emphasis in original).

Plaintiffs' boilerplate allegation that Merrill Lynch, and each and every other bank that ever provided underwriting services to Enron, was motivated to defraud because "top executives of the [nine underwriter defendants] constantly interacted with top executives of Enron . . . on almost a daily basis throughout the Class Period" (Compl. ¶¶ 653, 675, 694, 716, 736, 751, 763, 774, 788), is also insufficient. See *Vogel v. Sands Bros. & Co., Ltd.*, 126 F. Supp. 2d 730, 739 (S.D.N.Y. 2001) (underwriter's "alleged desire to realize greater transaction fees and its close relationship with [the issuer] are insufficient to show an improper motive"); *Sloane Overseas Fund, Ltd. v. Sapiens Int'l Corp., N.V.*, 941 F. Supp. 1369, 1377 (S.D.N.Y. 1996) (rejecting plaintiffs' allegation that "since SB was a founder, a substantial creditor, and a shareholder of Sapiens, and since SB was also the lead manager and underwriter of the offering, SB had ample motive to inflate Sapiens' financial soundness to ensure a successful and profitable offering").

For similar reasons, plaintiffs' allegations regarding Merrill Lynch's analyst reports likewise cannot satisfy even the lesser, and now rejected, pleading standard of "motive and opportunity." In yet another, but far more tortured, variation of the same theme, plaintiffs allege that Merrill Lynch was motivated to issue false analyst reports because "keeping Enron's stock price inflated was important to Merrill Lynch as it knew that if the stock price fell below certain 'trigger' prices, Enron would be required to issue millions of additional Enron shares which would reduce Enron's shareholders' equity by hundreds of millions if not billions of dollars, endangering its investment-grade credit rating, cutting off its access to the capital markets and thus endangering Merrill Lynch's ability to do securities underwriting for and other profitable transactions with Enron." Compl. ¶ 746.

In other words, even though it is undisputed that Merrill Lynch underwrote no public offerings of Enron securities after February 1999, plaintiffs once again contend that Merrill

Lynch was motivated to perpetrate fraud by the *prospect* of future fees. That is, once again, patently insufficient. *See In re WRT Energy Sec. Litig.*, No. 96 Civ. 3610, 1999 WL 178749, at *9 (S.D.N.Y. Mar. 31, 1999) (dismissing securities fraud complaint against underwriters alleged to have issued false analyst reports to inflate company's stock; "the Court reject[s] plaintiffs' allegations that Underwriter Defendants were motivated to commit fraud by the prospect of receiving $3.5 million in underwriting fees in connection with the Senior Notes Offering, and unspecified other fees as alleged advisors to WRT"); *Wenger v. Lumisys, Inc.*, 2 F. Supp. 2d 1231, 1251-52 (N.D. Cal. 1998) (rejecting plaintiffs' contention that defendants would "pocket millions from the IPO proceeds as the lead underwriters on the IPO and make millions more later by acting as marketmakers in Lumisys stock and by coordinating the sales of the Lumisys' insiders' stock" as alleged motive for underwriters to issue false analyst reports).

Plaintiffs' attempt to concoct a motive based on alleged "credit default puts" is even more spurious. According to plaintiffs, Merrill Lynch was motivated to issue false analyst reports at some unspecified time during 2000 or 2001 because Merrill Lynch "was obtaining millions of dollars by writing hundreds of millions of dollars of 'credit default puts' on Enron's publicly traded debt securities . . . [which] required Merrill Lynch to make good on Enron's publicly traded debt if Enron defaulted within a given time period, exposing Merrill Lynch to potentially large losses [so] Merrill Lynch wanted to help Enron keep its financial condition looking strong so its access to the credit market would continue." Compl. ¶ 743. In other words, plaintiffs illogically contend that, although Merrill Lynch supposedly knew that Enron's financial condition was precarious "by the beginning of the Class Period [October 1998]" (Compl. ¶ 748), Merrill Lynch nonetheless decided in 2000 or 2001 to expose itself to the risk of "potentially

large losses" by writing "hundreds of millions of dollars of credit default puts" predicated on the strength of Enron's financial condition.

When the legal sufficiency of a pleading is challenged, the plaintiffs are not entitled to have the Court draw this kind of utterly irrational inference. As courts have made clear, "where plaintiff's view of the facts defies economic reason, it does not yield [even] a reasonable inference of fraudulent intent." *Kalnit v. Eichler*, 264 F.3d 131, 140-41 (2d Cir. 2001); *see also Coates v. Heartland Wireless Communications, Inc.*, 55 F. Supp. 2d 628, 643 (N.D. Tex. 1999) (rejecting plaintiffs' theory of fraud because it "defies common sense").

Quite the contrary to plaintiffs' absurd conclusions, Merrill Lynch's alleged writing of "credit default puts" in 2000 and 2001 actually *negates* any inference that Merrill Lynch believed Enron's financial condition to be precarious because, as plaintiffs themselves allege, the "credit default puts" were predicated on the *strength* of Enron's financial condition. *See In re Sun Healthcare Group, Inc. Sec. Litig.*, 181 F. Supp. 2d 1283, 1297 (D.N.M. 2002) ("It is difficult to discern how Defendants could be acting in their self-interest by holding or purchasing artificially inflated Sun stock, as well as acquiring a company that they allegedly knew was doomed for failure under PPS. Motive, therefore, is entirely absent from Plaintiffs' Complaint."); *Kas v. Chase Manhattan Bank, N.A.*, No. 90 Civ. 33, 1990 WL 113185, at *3 (S.D.N.Y. July 30, 1990) ("The court notes further that the complaint contains information that actually undermines an inference of scienter. In the case at bar, Citibank and Chase themselves, according to the complaint, were willing to provide a considerable amount of the financing.").

In sum, plaintiffs have failed to plead any facts that would support any inference of motive on the part of Merrill Lynch to perpetrate fraud.

3. The Complaint Is Barren Of Any Facts Suggesting Conscious Misbehavior Or Severe Recklessness By Merrill Lynch

Where, as here, plaintiffs have failed to allege any motive for a defendant to commit fraud, plaintiffs face an even more stringent pleading standard. Indeed, "absent an apparent motive to commit fraud . . . the strength of the circumstantial evidence [of conscious misbehavior] must be *correspondingly greater*." *Physicians Resource Group*, 2002 WL 318441, at *10; *see also BMC Software*, 183 F. Supp. 2d at 896 ("where the motive is not evident . . . the strength of the circumstantial allegations must be *correspondingly greater*") (emphasis added). As discussed below, plaintiffs do not meet this standard as to Merrill Lynch.

a) Merrill Lynch As Underwriter And Analyst

Saddled with this strict legal standard, the most plaintiffs muster is a conclusory assertion that "Merrill Lynch knew that Enron was falsifying its publicly reported financial results . . . due to its access to Enron's internal business and financial information as one of Enron's main underwriters and financial advisors, as well as its intimate interaction with Enron's top officials which occurred virtually on a daily basis." Compl. ¶ 748; *see also* Compl. ¶ 650 ("each of the banks named as defendants obtained and retained extremely detailed information concerning the actual financial condition of Enron"). Even as to an issuer, this Court has held that "conclusory allegations that [the company's officers] had the requisite scienter based on their executive positions . . . their involvement in day-to-day management of its business, their access to internal corporate documents, their conversations with corporate officers and employees, and their attendance at Board meetings are insufficient." *BMC Software*, 183 F. Supp. 2d at 887. Such allegations fail to "allege what information they knew, or when or how they learned it." *Id.* at 915; *see also Kurtzman v. Compaq Computer Corp.*, Civ. A. No. H-99-779, slip op. at 125 (S.D. Tex. Dec. 12, 2000) (Harmon, J.) ("Plaintiffs also rely on knowledge acquired by reason of the

high level positions held by defendants at Compaq. This global allegation, too, lacks any factual specifics as to what information they were exposed, how, and when.").

Not surprisingly, the same type of conclusory allegation has been repeatedly rejected when it is asserted against an issuer's underwriter, since underwriters obviously have even less knowledge about an issuer than do an issuer's officers and directors. *See In re Landry's Seafood Restaurant, Inc. Sec. Litig.*, Civ. A. No. H-99-1948, slip op. at 66 (S.D. Tex. Feb. 19, 2001) (Harmon, J.) (dismissing securities fraud claim based on allegation that underwriters "had access to confidential corporate information and communicated frequently with Fertitta and West [the company's officers] about the business" because "plaintiffs fail to provide any details or identify specifically what kind of information, when it was conveyed, by whom and to whom"); *Marks v. Simulation Sciences*, No. CV-98546, 2000 WL 33115589, at *2 (C.D. Cal. Feb. 28, 2000) (rejecting any inference of scienter based on allegation that underwriters "had 'intimate access' to internal documents and information and were in constant contact with Harris and Pfeiffer [the company's officers] about 'intimate details' of SimSci's business"); *In re Stratosphere Corp. Sec. Litig.*, 1 F. Supp. 2d 1096, 1122 (D. Nev. 1998) (rejecting any inference of scienter based on allegation that defendants "were co-lead underwriters for the December 1995 stock offering, and . . . had access to Stratosphere and its top executives").

Plaintiffs have failed to identify anyone at Merrill Lynch who knew, at the time he or she made any statement concerning Enron, that such statement was misleading. The Complaint is devoid of any facts, much less particularized facts, explaining how Merrill Lynch knew, at the time of the offerings in which it participated, or at the time it issued its analyst reports, that any of Enron's reported financial results was false or misleading. *See Lumisys*, 2 F. Supp. 2d at 1251 (dismissing securities fraud complaint because "plaintiff fails to demonstrate anywhere in the

complaint that . . . the underwriters w[ere] aware of any allegedly 'adverse' information at the time the Prospectus was issued").

Indeed, plaintiffs do not, and cannot, identify any documents or other information that came to Merrill Lynch's attention that would have led it to believe that the Enron financial statements were false. *See Elliot Assocs., L.P. v. Covance, Inc.*, No. 00 Civ. 4115, 2000 WL 1752848, at *7 (S.D.N.Y. Nov. 28, 2000) ("to withstand a motion to dismiss, plaintiffs must detail specific contemporaneous data or information known to the defendant that was inconsistent with the representation in question"); *Branca v. Paymentech, Inc.*, No. Civ. A. 3:97-CV-2507-L, 2000 WL 145083, at *10 (N.D. Tex. Feb. 8, 2000) ("Plaintiffs have pleaded no facts indicating that at the time the allegedly false statements were made, defendants had actual knowledge of contradictory facts, and thus their complaint does not state a claim for securities fraud.").

Nor do plaintiffs allege that Enron's auditors (who are themselves alleged to have been participants in Enron's fraud) gave Merrill Lynch any reason to doubt the accuracy and fair presentation of Enron's financial statements. Arthur Andersen's opinions were unqualified year after year, as the Complaint itself stresses. Compl. ¶ 899. *See Sapiens*, 941 F. Supp. at 1377 (dismissing securities fraud complaint because "short of conducting a financial audit, which plaintiffs do not contend the Underwriters should have done, the Underwriters were not in a position to discover any of the fraudulent schemes which caused injury to plaintiffs").

In sum, the allegations against Merrill Lynch describe nothing more than a paradigmatic underwriting relationship. If this Complaint is adequate, then all underwriters are subject to Rule 10b-5 liability every time the issuer allegedly perpetrates a fraud. Because of the absence of any specific allegation that Merrill Lynch knew that any part of its analyst reports or the

offering documents for the Enron offerings was false, plaintiffs' Section 10(b) claim relating to those documents must be dismissed. *See Chan*, 1998 WL 1018624, at *23 (dismissing securities fraud complaint because "plaintiffs have failed to point to any facts establishing that the underwriters had any knowledge that the statements were misleading").

b) Merrill Lynch's Role With Respect To LJM2

Plaintiffs also attempt to show scienter based on Merrill Lynch's involvement with LJM2. According to plaintiffs, Merrill Lynch must have known about Enron's precarious financial condition because Merrill Lynch was a placement agent for, and limited partner in, the LJM2 limited partnership formed in late 1999. *See* Compl. ¶¶ 740-42. Plaintiffs' allegations about LJM2 could only relate to Merrill Lynch's issuance of analyst reports after December 1999.[14]

Merrill Lynch's role as placement agent for the LJM2 investment, however, has no bearing whatever on Merrill Lynch's knowledge of the alleged misuse of LJM2 by Enron or LJM2 Capital Partners, the general partner of LJM2 controlled by "three top insiders of Enron." Compl. ¶ 740. On this point, the court's decision in *Boley v. Pineloch Assocs., Ltd.*, No. 87 Civ. 5124, 1990 WL 113201 (S.D.N.Y. Aug. 2, 1990), is particularly instructive:

> [O]nly Clark and Pineloch Associates, as Managing General partner, the only defendants purporting to exercise day-to-day management control over the Project and the only defendants geographically near to the Project in Texas, would have had primary knowledge of Pineloch's operations. The Cornerstone defendants, all based in New York, were not involved in day-to-day operations and, as Placement Agent, Administrative Service Entity, and Administrative General Partner, performed brokerage services and administrative functions.

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[14] Plaintiffs do not and cannot offer any explanation as to how Merrill Lynch's involvement with the LJM2 partnership in late 1999 has any relationship to the offerings in which Merrill Lynch participated, all of which occurred long before LJM2 was formed in December 1999, or to the seven analyst reports and "statements to the media" allegedly made by Merrill Lynch prior to December 1999.

> Thus, facts such as Clark's net worth, liquidity, and capability and intention of meeting Partnership obligations, whether proceeds from the sale of limited partnership interests were misappropriated, whether the Cal Fed loan was closed without the required safeguards, whether excessive rental concessions impaired the Partnership's ability to service the loan, whether the property was overvalued, and whether the economic projections in the Memorandum were unreasonably optimistic, were all in the first instance known only to Clark. Even if defendants were remiss in relying on Clark for this information, this would not amount to fraudulent intent.

Id., at *8-9 (dismissing securities fraud claim against placement agent).

Similarly, there is no allegation here that Merrill Lynch, as placement agent for the LJM2 partnership, had any control over the day-to-day operations of the LJM2 limited partnership from which knowledge of the misuse of the limited partnership might be inferred. To the contrary, plaintiffs concede that "LJM2's day-to-day activities w[ere] run by three top insiders of Enron, *i.e.*, Fastow, Kopper and Glisan." Compl. ¶ 740. The Complaint is simply devoid of any specific allegation explaining *how* Merrill Lynch allegedly "knew that LJM2 was not independent of Enron and was to be used and was used to engage in non-arm's-length transactions to boost Enron's reported profits." Compl. ¶ 742.

Plaintiffs fare no better with Merrill Lynch's alleged status as a limited partner in LJM2, a Delaware limited partnership. It is well established that a limited partner is "a passive investor similar to a corporate shareholder." *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 714 A.2d 96, 99 (Del. Ch. 1998). *See also* Private Placement Memorandum, at 30 ("Limited Partners will be relying entirely on the General Partner and Manager to conduct and manage the affairs of the Partnership. The Agreement will not permit the Limited Partners to engage in the active management and affairs of the corporation."). Again, plaintiffs make no allegation regarding how Merrill Lynch supposedly knew that LJM2 was being used for improper purposes. *See In re Cybershop.com Sec. Litig.*, 189 F. Supp. 2d 214, 235-36 (D.N.J. 2002) (dismissing

securities fraud complaint with prejudice; "Where plaintiffs contend defendants had access to contrary facts, they must specifically identify the reports or statements containing this information.").

As a last resort, plaintiffs argue that fraud should be inferred simply because Merrill Lynch and other limited partners "put their money up early in 12/99 so LJM2 would have the cash to fund four SPEs to do deals with Enron at year-end 99." Compl. ¶ 741. Knowledge of the sale of assets from Enron to LJM2, however, has no bearing on whether Merrill Lynch or the other limited partners knew that LJM2 would be misused by Enron or its employees.[15]

In the absence of any specific allegation about how Merrill Lynch knew that LJM2 would be used to engage in "sham transactions," plaintiffs cannot adequately plead that Merrill Lynch believed Enron's financial condition to be "precarious" at the time it issued its analyst reports on Enron.[16] *See Calliot v. HFS, Inc.*, No. Civ. A. 3:97-CV-0924-I, 2000 WL 351753, at *8 (N.D. Tex. Mar. 31, 2000) (dismissing securities fraud complaint with prejudice because "plaintiffs

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[15] There is nothing inherently fraudulent about Enron's alleged desire to sell assets to LJM2 before year-end. Companies routinely seek to dispose of assets before year-end for, among other reasons, tax purposes. *See Rieger v. Price Waterhouse Coopers LLP*, 117 F. Supp. 2d 1003, 1008-09 (S.D. Cal. 2000) (rejecting inference of fraudulent intent based upon allegation that "Altris recorded both transactions on the last day of the year" because "the timing and structuring of these transactions does not inherently suggest fraud, and could suggest a desire to obtain more favorable tax or regulatory treatment"). Similarly, there is nothing inherently fraudulent about the alleged desire to form the LJM2 limited partnership before year-end. *See Hallwood*, 714 A.2d at 99 n.6 ("the limited partnership attracts promoters and investors because it combines passive investment . . . with the favorable tax treatment of a partnership"). Plaintiffs offer no factual support whatsoever for their conclusory assertion that "the banks . . . knew Enron doing the 99 year-end deals with the LJM2 SPEs was indispensable to avoiding Enron reporting a very bad 4th Q 99 and year-end 99." Compl. ¶ 647.

[16] Plaintiffs also fail to supply any factual support for their conclusory allegations concerning Azurix, including that Merrill Lynch "knew . . . that Enron had grossly overpaid for Wessex and that Enron's worldwide water business was very unlikely to succeed." Compl. ¶ 739.

have pleaded no facts indicating that at the time the allegedly false statements were made, defendants had actual knowledge of contradictory facts").

Plaintiffs are, in effect, reduced to arguing that, because Enron restated its financial results, Merrill Lynch must have known of the fraud at the time it issued its analyst reports. Far more is required to charge a professional with securities fraud. *See Physicians Resource Group*, 2002 WL 318441, at *10 ("Plaintiffs may not rely on fraud by hindsight to establish a claim for securities fraud. Mere allegations that statements in one report should have been made in earlier reports do not make out a claim for securities fraud"); *Stack v. Lobo*, No. Civ. 95-20049, 1995 WL 241448, at *3 (N.D. Cal. Apr. 20, 1995) ("Plaintiffs have failed to allege any facts in support of their § 10(b) claims with sufficient particularity to satisfy Fed. R. Civ. P. 9(b). Instead, plaintiffs have concocted a classic 'fraud by hindsight' case. Plaintiffs' FAC contains substantial amounts of boilerplate language, and is devoid of any contemporaneous facts which tend to show that any statements made by the . . . Underwriters were false when made.").

Accordingly, plaintiffs' Section 10(b) claim against Merrill Lynch must be dismissed for failure to plead any facts that would permit the strong inference that Merrill Lynch acted with the necessary scienter. *See Vogel*, 126 F. Supp. 2d at 743 (dismissing securities fraud complaint against underwriter alleged to have issued false analyst reports because "while plaintiffs contend that defendant had access to facts that contradict these generally optimistic reports . . . plaintiffs fail to specifically identify the reports or statements containing this information").

D. Plaintiffs Cannot Impose Secondary Liability On Merrill Lynch Because The Supreme Court Has Held That No Such Private Action Exists

As a fallback, plaintiffs contend that even if Merrill Lynch cannot be held liable for any of its own statements, Merrill Lynch should nonetheless be held liable for its alleged "knowing participation in manipulative devices, fraudulent scheme, course of conduct and fraudulent

course of business *of Enron.*" Compl. ¶ 749 (emphasis added). Plaintiffs' transparent attempt to impose secondary liability on Merrill Lynch for Enron's alleged fraud also should be rejected.

1. *Central Bank* Precludes Claims For Aiding And Abetting

In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver,* 511 U.S. 164 (1994), the Supreme Court rejected nearly thirty years of jurisprudence in lower courts that had allowed private plaintiffs to maintain actions under Section 10(b) for aiding and abetting. Prior to *Central Bank*, a generation of lawsuits flourished in which secondary actors were alleged to have "substantially assisted" in primary violations committed by others. *See id.* at 169; *id.* at 192 n.1 (Stevens, J., dissenting) (collecting cases). In *Central Bank*, however, the Supreme Court held that Section 10(b) and Rule 10b-5 did *not* imply a private right of action against those who aided and abetted a violation of those provisions. The principal grounds for the holding were that: (1) the text of Section 10(b) does not prohibit aiding and abetting; and (2) permitting a cause of action for aiding and abetting would impose liability on a defendant without requiring a plaintiff to prove as to that defendant each element of a violation of Section 10(b). 511 U.S. at 179-80, 191. The Court made clear that, to impose liability under Section 10(b), "*all* of the requirements for primary liability under Rule 10b-5 [must be] met." *Id.* at 191 (emphasis in original).

Writing in dissent, Justice Stevens noted that the majority's decision in *Central Bank* likely sounded the death-knell for all forms of secondary liability under Section 10(b) including, for example, conspiracy. *Id.* at 200, n.12. Just as Justice Stevens predicted, virtually "every court to have addressed the viability of a conspiracy cause of action under § 10(b) and Rule 10b-5 in the wake of *Central Bank* has agreed that *Central Bank* precludes such a cause of action." *Dinsmore v. Squadron, Ellenoff, Plesent, Sheinfeld & Sorkin*, 135 F.3d 837, 841 (2d Cir. 1998). *See also Erickson* v. *Horing*, No. 99-1468, 2001 WL 1640142, at *12 n.12 (D. Minn. Sept. 21, 2001) ("The conspiracy-like allegations contained throughout the second amended

complaint also fail as a matter of law. . . . Courts since *Central Bank* have found that allegations of conspiracy or common scheme do not create liability under Section 10(b).").

In fact, all Courts of Appeals that have addressed the impact of the Supreme Court's decision in *Central Bank*, save one, have adopted a "bright line" test for liability under Section 10(b) and rejected attempts to impute liability to secondary actors based upon alleged "substantial participation" in a primary violation committed by another. *See, e.g., Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001) ("Plaintiffs base their claim on GY&S's 'significant role in drafting, creating, reviewing or editing allegedly fraudulent letters or press releases.' Such allegations of substantial assistance in the alleged fraud were the kinds of allegations that were rejected in *Central Bank.*"); *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997) ("If *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b). . . . Allegations of 'assisting,' 'participating in,' 'complicity in' and similar synonyms used throughout the complaint all fall within the prohibitive bar of *Central Bank.*") (citations omitted); *Wright v. Ernst & Young LLP*, 152 F.3d 169 (2d Cir. 1998) (same); *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1226 (10th Cir. 1996) ("Reading the language of § 10(b) and 10b-5 through the lens of *Central Bank of Denver*, we conclude that in order for [secondary actors] to 'use or employ' a 'deception' actionable under the antifraud law, they must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors. In addition to being consistent with the language of the statute, this rule, though far from a bright line, provides more guidance to litigants than a rule

allowing liability to attach to an accountant or other outside professional who provided 'significant' or 'substantial' assistance to the representations of others.").[17]

The weight of authority is thus clear that *Central Bank* has eliminated all forms of secondary liability under Section 10(b).[18] In the present case, moreover, plaintiffs do not even allege that Merrill Lynch played a "significant role" in drafting any of the statements by Enron alleged to be false and misleading.

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[17] The sole exception is buried in a footnote of a decision by the Ninth Circuit. *See In re Software Toolworks, Inc.*, 50 F.3d 615, 628 n.3 (9th Cir. 1994) ("The plaintiffs presented evidence that Deloitte played a significant role in drafting and editing the July 4 SEC letter. This evidence is sufficient to sustain a primary cause of action under Section 10(b) and, as a result, *Central Bank* does not absolve Deloitte on these issues."); *see also McNamara v. Bre-X Minerals Ltd.*, 57 F. Supp. 2d 396, 429 (E.D. Tex. 1999) (adopting *Software Toolworks*). Neither the Ninth Circuit nor the district court in *Bre-X* offered any explanation how a defendant's alleged "significant role" in the primary violation of another in any way differed from the "substantial assistance" element of the aiding and abetting cause of action rejected by the Supreme Court in *Central Bank*. *See Anixter*, 77 F.3d at 1226 n.10 (criticizing *Software Toolworks* and district court decisions adopting *Software Toolworks* without consideration of how a "significant role" standard in any way differs from the "substantial assistance" element of the aiding and abetting cause of action); *Wright*, 152 F.3d at 175-76 (rejecting *Software Toolworks*); *Ziemba*, 256 F.3d at 1194 (same).

[18] The following is a non-exhaustive list of cases in which courts have held that *Central Bank* forecloses the imposition of liability under Section 10(b) for alleged "substantial participation" in a primary violation committed by another party: *Roer v. Oxbridge Inc.*, No. 99 Civ. 5018, 2001 WL 1840924, at *11 (E.D.N.Y. Sept. 28, 2001); *Great Neck Capital Appreciation Inv. P'ship, L.P. v. PricewaterhouseCoopers, L.L.P.*, 137 F. Supp. 2d 1114, 1120-21 (E.D. Wis. 2001); *Copland v. Grumet*, 88 F. Supp. 2d 326, 331-33 (D.N.J. 1999); *Kreiger v. Gast*, No. 98 C 3182, 1998 WL 677161, at *9 (N.D. Ill. Sept. 22, 1998); *Malin v. Ivax Corp.*, 17 F. Supp. 2d 1345, 1361 (S.D. Fla. 1998); *Molinari v. Symantec Corp.*, No. C-97-20021, 1998 WL 78120, at *11 n.6 (N.D. Cal. Feb. 17, 1998); *Chan*, 1998 WL 1018624, at *17; *Oak Tech.*, 1997 WL 448168, at *15; *Valence*, 1996 WL 37788, at *11; *Lycan v. Walters*, 904 F. Supp. 884, 901 n.12 (S.D. Ind. 1995); *Strassman*, 1995 WL 743728, at *17; *In re Ross Sys. Sec. Litig.*, No. C-94-0017, 1994 WL 583114, at *3-4 (N.D. Cal. July 21, 1994); *Arena Land & Inv. Co. v. Petty*, 906 F. Supp. 1470, 1478 (D. Utah 1994).

2. The Court Should Reject Plaintiffs' Effort To Recharacterize An Aiding And Abetting Claim As A Primary Violation

Here, plaintiffs seek to circumvent *Central Bank*, not to mention the strict pleading requirements of Rule 9(b) and the PSLRA, by attempting to repackage an aiding and abetting claim as if it were somehow a "primary" claim: "Merrill Lynch is directly liable to the Class . . . for its knowing participation in manipulative devices, fraudulent scheme, course of conduct and fraudulent course of business of Enron, which operated to defraud purchasers of Enron's publicly traded securities during the Class Period." Compl. ¶ 749; *see also id.* ¶ 747 ("In addition to its own direct liability for making false and misleading statements, Merrill Lynch also participated in and furthered the fraudulent scheme by helping to finance or otherwise participate in illicit transactions with Enron which it knew would contribute materially to Enron's ability to continue to falsify its financial condition . . . .").

Courts, however, have rejected efforts to evade *Central Bank* by purporting to base liability on allegations that defendants "participated in" a "scheme to defraud." *See Oak Tech.*, 1997 WL 448168, at *15 ("Plaintiffs argue that [defendant underwriters], in their efforts to substantially assist the huge insider sales of Oak stock, participated in a scheme designed to defraud the investing public. . . . [P]ursuant to the Supreme Court's ruling in *Central Bank*, secondary liability claims based on allegations of conspiracy are not actionable under Section 10(b). Thus, plaintiffs' claims of H&Q's participation in a scheme to defraud investors must be dismissed."); *Valence*, 1996 WL 37788, at *11 (dismissing securities fraud complaint against underwriter because "the allegation that [the underwriter] participated in a scheme to defraud is merely an attempt to state a cause of action for Section 10(b) 'aiding and abetting'"); *Strassman*, 1995 WL 743728, at *17 ("Plaintiffs attempt to hold the Underwriters liable for such statements through allegations that the Underwriters are part of a 'scheme to defraud' investors.

However, plaintiffs' 'scheme to defraud' claims are barred by *Central Bank.*"); *Stack*, 1995 WL 241448, at *10 (dismissing securities fraud complaint against underwriters because "plaintiffs' 'scheme' allegations are no more than a thinly disguised attempt to avoid the impact of the *Central Bank* decision").

Characterizing Merrill Lynch as a participant in a "manipulative device" (Compl. ¶ 749) also does not salvage plaintiffs' claim. "'Manipulation' is 'virtually a term of art when used in connection with securities markets.' . . . The term refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity." *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977) (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. at 199). Here, there is nothing that Merrill Lynch is alleged to have done that constitutes "activities in the marketplace" for Enron securities, such as contemplated by *Santa Fe*. *See Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349, 1359 (N.D. Tex. 1979) (Higginbotham, J.); *see also id.* at 1360 (manipulative devices are "practices in the marketplace which have the effect of either creating the false impression that certain market activity is occurring when in fact such activity is unrelated to actual supply and demand or tampering with the price itself").

Furthermore, the only conduct of Merrill Lynch alleged in this regard is serving as placement agent for LJM2 and investing as a limited partner in LJM2. The formation and capitalization of LJM2, in and of themselves, are not alleged to have had any impact whatsoever on Enron or the market for Enron securities. There is no allegation, for instance, nor could there be, that plaintiffs relied upon any statement in the LJM2 private placement memorandum, or on the fact that Merrill Lynch invested as a limited partner in LJM2. Indeed, plaintiffs make a special point of alleging that the LJM2 private placement memorandum "***was not a public***

document," and therefore they could not allege any reliance. Compl. ¶ 646 (emphasis in original). *See Central Bank*, 511 U.S. at 180 ("A plaintiff must show reliance on the defendant's misstatement or omission to recover under 10b-5. Were we to allow the aiding and abetting action proposed in this case, the defendant could be liable without any showing that the plaintiff relied upon the aider and abettor's statements or actions. Allowing plaintiffs to circumvent the reliance requirements would disregard the careful limits on 10b-5 recovery mandated by our earlier cases."); *Ziemba*, 256 F.3d at 1205-06 (same).

Rather, according to plaintiffs, it was the subsequent transactions between Enron and Enron-related entities (SPEs) that in turn had dealings with LJM2 – and, more precisely, *Enron's alleged failure to account for those transactions properly* – that caused a misstatement of Enron's financial statements and the alleged harm to plaintiffs. *See, e.g.*, Compl. ¶ 464 ("Transactions with the Raptors . . . allowed Enron to improperly avoid reflecting almost $1 billion [in] merchant investments losses on its income statement"), ¶ 470 ("the transaction was done solely to allow Enron to improperly record the sale of loans as income in 99"), ¶ 476 ("non-consolidation of these entities was improper"), ¶ 488 ("Enron improperly recorded an accounting gain related to the Hawaii transactions"), ¶ 646 (LJM2 "was used to help create numerous SPEs . . . with which Enron engaged in illusory transactions to artificially inflate Enron's profits while concealing billions of dollars in debt that should have been on Enron's balance sheet"). As such, plaintiffs' claim is merely one for alleged misrepresentations *by Enron*, and not for any alleged statement by Merrill Lynch or any use of any "manipulative device" by Merrill Lynch. At most, plaintiffs allege that Merrill Lynch's involvement with LJM2 assisted Enron in carrying out its

misrepresentations.[19] This, however, is a classic "aiding and abetting" claim, which is now precluded by *Central Bank*. *See Shapiro*, 123 F.3d at 721 ("Plaintiffs' argument is best summarized in its statement that the [secondary actor] defendants were in complicity throughout with the principal defendants. This assertion of aiding and abetting does not support a claim under § 10(b) as interpreted by the *Central Bank* court."); *Advanced Laser Prods., Inc.* v. *Signature Stock Transfer, Inc.*, No. Civ. A. 3:98-CV-1624-D, 1999 WL 222385, *2 n.2 (N.D. Tex. Apr. 12, 1999) ("To the extent that Advanced alleges that Union 'acted in complicity' with Quinn's theft of securities, Advanced has failed to assert an act that violates § 10(b) and Rule 10b-5. The Supreme Court has held that a private plaintiff may not maintain an aiding and abetting action under § 10(b).").

As the Supreme Court made clear in *Central Bank*, to state a Section 10(b) claim, the plaintiff must prove, as to each defendant, *each* element of a violation of Section 10(b). *See Central Bank*, 511 U.S. at 191 (actors may only be liable if "*all* of the requirements for primary liability under Rule 10b-5 are met") (emphasis in original). Insofar as plaintiffs purport to base their claim against Merrill Lynch on any conduct *other than* Merrill Lynch's own statements, their claims are barred by *Central Bank* because they fail to allege any actionable conduct *by* Merrill Lynch.[20]

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[19] In fact, Merrill Lynch's involvement is at least several steps removed from the alleged misrepresentations by Enron. LJM2 itself is not alleged to have participated in the alleged misrepresentations, and Merrill Lynch was merely a passive limited partner in LJM2.

[20] To the extent plaintiffs intend to allege "control person" liability against Merrill Lynch under § 20(a) of the Exchange Act, *see* Compl. ¶ 995 ("[d]efendants" violated Sections 10(b) "and/or" 20(a)), that claim, too, fails because plaintiffs have not alleged any facts to support such a claim (or even that Merrill Lynch controlled any other defendant). *See, e.g.*, *Sapiens*, 941 F. Supp. at 1378-79 (dismissing Section 20(a) claim against underwriter because "if

[Footnote continued on next page]

Plaintiffs' secondary liability theory falls for a separate, independent reason as well. As set forth above (*see supra* Section C), a critical missing link in plaintiffs' Complaint is any factual allegation that would support any inference, much less a *strong* inference, that Merrill Lynch engaged in any wrongful conduct while knowing Enron's financial condition to be precarious. *See Schnell v. Conseco, Inc.*, 43 F. Supp. 2d 438, 448-49 (S.D.N.Y. 1999) (dismissing Section 10(b) manipulation claim against underwriter because "plaintiff has failed to properly plead scienter").

Just like plaintiffs' theory of primary liability, therefore, plaintiffs' theory of secondary liability – even if it could survive *Central Bank* – should be dismissed for failure to plead facts supporting a strong inference of fraudulent intent and failure to plead fraud with particularity. *See Smith v. Ayres*, 845 F.2d 1360, 1365 (5th Cir. 1988) (dismissing pre-*Central Bank* aiding and abetting claim because plaintiff "alleged no facts supporting an inference of substantial or knowing assistance"); *Manela v. Gottlieb*, No. 91 Civ. 5510, 1993 WL 8176, at *7 (S.D.N.Y. Jan. 4, 1993) (dismissing pre-*Central Bank* aiding and abetting claim because "neither MSBB nor its partner Lipkin . . . are [] alleged to have possessed either a high conscious intent or a conscious and specific motivation to aid the fraud as required").

[Footnote continued from previous page]

plaintiff seeks to attribute control status to a third party . . . such as an attorney, auditor or underwriter, then further factual allegations must be made to show that in fact such control can be inferred"); *In re VMS Sec. Litig.*, 752 F. Supp. 1373, 1399 (N.D. Ill. 1990) ("A sundry of defendants are labelled 'controlling persons' of the Funds and are charged with liability for misrepresentations under § 20(a) of the 1934 Securities Exchange Act. . . . [I]t is clear that the underwriters, guarantors, advisors and appraisers cannot be liable [under § 20(a)] as controlling persons. Plaintiffs have not alleged facts to indicate that any of these defendants had the authority to control the operation of the Funds.").

In sum, this Court should reject plaintiffs' transparent attempt to impute secondary liability to Merrill Lynch based upon conclusory allegations that it "participated in" Enron's purported fraud.

CONCLUSION

For all of these reasons, this Court should dismiss plaintiffs' Consolidated Complaint against Merrill Lynch with prejudice and grant such other and further relief as it deems appropriate.

Dated: May 8, 2002

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